MOTION FILED
JUL 29 1982

No. 81-523

In the Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from The Court of Appeal of California, First Appellate District

Motion of the Committee on Unitary Tax To File Brief Amicus Curiae

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The Committee on Unitary Tax (hereafter "CUT") respectfully moves this Court for leave to file in the case now pending, set for argument this fall, this brief *amicus curiae* that it previously filed in the case of *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.,* Supreme Court No. 81-349, argued this spring. The interest of *amicus curiae* and the reasons for granting the motion are stated below.

Amicus curiae is a California nonprofit corporation, comprised of members concerned with state taxation of international business and in particular with taxation by California of such business. Members principally include corporations organized under the law of other nations and the United States subsidiaries of such non United States corporations, but also include corporations organized under the law of various states of the United States and individuals.

Many of the members of CUT are corporations doing business in California (hereafter "California corporations") which have parent and affiliated corporations doing no business in California. Nevertheless, California has sought to include the worldwide income of such parents and affiliates in combined tax reports with such California corporations in the same fashion which it has included worldwide income from the foreign subsidiaries in the combined reports filed by appellant Container Corporation of America in this case.

This Court's recent decisions in *ASARCO, Incorporated v. Idaho State Tax Commission,* ..... U.S. ..... (1982) and *F. W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico,* ..... U.S. ..... (1982) set forth standards under the Due Process Clause of the United States Constitution for taxation by a state of income earned by entities not doing business within the state. These decisions may very well dispose of this case since the operations of appellant Container Corporation of America in the United States seem discrete and separate from those of its foreign subsidiaries. Thus, this Court may not reach other important issues which arise under both the Due Process Clause and under the Commerce Clause.

Should, however, the Court choose to reach such other issues which are posed by appellant Container Corporation of America in this case, the Brief to be filed by amicus curiae not only addresses those issues but points up the differences in degree of impact and burden on foreign parents with domestic subsidiaries. These differences have not been addressed by the courts below and they will not be addressed by the parties in this case. Amicus curiae has received consent from appellant to file this Brief, a copy of which is included as Exhibit A, and understands that a

general consent has been given by appellee, Franchise Tax Board.

This Brief was originally filed in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, Supreme Court No. 81-349, pursuant to the consent of the parties in that case. The California combined reporting method under consideration in this case has the same infirmities as the Illinois method under consideration in that case. Thus, although this Brief refers to *Chicago Bridge & Iron Co.* as the appellant and to the Illinois tax system, legal issues and authorities cited in this Brief remain applicable to this case.

Amicus curiae therefore respectfully requests that the Court accept the Brief as previously filed by amicus curiae in the *Chicago Bridge & Iron Co.* case for filing in this case. Amicus submits herewith forty copies of that Brief.

Respectfully submitted,

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Appendix A

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Re: Container Corporation of America v.
Franchise Tax Board, U.S. Supreme Court
No. 81-523

Dear Joanne:

As counsel for Container Corporation of America, I consent to the filing of an *amicus* brief by the Committee on Unitary Tax in the above case.

Sincerely,

/s/ FRANKLIN C. LATCHAM

Franklin C. Latcham

FCL:as

No. 81-349

In the Supreme Court of the United States

OCTOBER TERM, 1981

CHICAGO BRIDGE & IRON COMPANY,
Appellant

vs.

CATERPILLAR TRACTOR CO.,
ILLINOIS DEPARTMENT OF REVENUE, et al.,
Appellees

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In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-349

CHICAGO BRIDGE & IRON COMPANY,

Appellant

vs.

CATERPILLAR TRACTOR CO.,
ILLINOIS DEPARTMENT OF REVENUE, et al.,

Appellees

Appeal from the Supreme Court of Illinois

Brief for Committee on Unitary Tax as Amicus Curiae

INTEREST OF AMICUS

The Committee on Unitary Tax hereby respectfully files this Amicus Curiae Brief in support of Appellant Chicago Bridge & Iron Company. The consents of the attorneys for Appellant and for Appellees are attached hereto as Appendices "A," "B," and "C."

Amicus Curiae is a California nonprofit corporation comprised of members concerned with state taxation of international business. Members principally include corporations organized under the laws of other nations and United States subsidiaries of such non United States corporations, but also include corporations organized under

the laws of various states of the United States and individuals.[1]

SUMMARY OF ARGUMENT

Since a portion of the income which may be subject to tax by Illinois under worldwide combined reporting of separate entities, including those incorporated and doing business in foreign nations, was earned in foreign commerce, the additional inquiries developed in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979) should apply to test compliance of the Illinois corporate income tax with the Commerce Clause.

Worldwide combined reporting fails the first inquiry under *Japan Line* because it substantially increases the risk of multiple taxation of international businesses. Combined reporting ignores geographic boundaries whereas the international standard of taxation uses a separate accounting approach based on geographic boundaries. Multiple taxation will occur where a foreign sovereign taxes to its water's edge, and the state share of income determined by worldwide combined reporting exceeds U.S. source (i.e., U.S. water's edge) income. This Court has no jurisdiction to force a foreign sovereign to accept apportionment of taxes in preference to that sovereign's method of taxation. Thus, this Court cannot insure that the aggregation of taxes is computed on no more than the total net income of an international business. Because this risk of multiple taxation is identifiable and is inherent in the system, proof of risk, rather than proof of actual multiple taxation should be sufficient.

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1. The countries of incorporation of members, or parent corporations of members, include Japan, the United Kingdom, The Netherlands, Switzerland, Korea, West Germany and Canada.

Worldwide combined reporting also fails the second *Japan Line* test because it impairs federal uniformity and increases the risk of international disputes over reconciliation of apportionment formulae at a time when the federal government has entered into a number of taxation treaties with the dual goals of establishing uniformity of treatment and removing impediments, including double taxation, to the free flow of trade. The multiplicity of non-uniform state taxing systems further exposes foreign commerce to inconsistent treatment, thus preventing the Nation from speaking with one voice. Although this case involves domestic corporations, combined reporting has already resulted in numerous objections from foreign nations with the possible risk of retaliation should it be applied to entities owned and controlled by foreign-based businesses. This Court can avoid such difficulties by confining combined reporting to the United States.

Finally, worldwide combined reporting fails the fair apportionment and lack of discrimination tests for compliance with the Commerce Clause as established by *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), particularly when applied to foreign owned businesses. Arbitrary and distorted results occur from such application because of the differences in economic and political systems, and the cost of compliance by foreign owned unitary businesses increases to such a degree as to be discriminatory.

ARGUMENT

The Illinois Supreme Court has ruled in this case that it is proper to combine the incomes of separately incorporated corporations doing business within and without the United States to determine the share of income which Illinois may tax under its income tax. This case involves a United States domestically incorporated parent (Cater-

pillar Tractor Co.) with numerous subsidiaries, including several incorporated under the laws of foreign countries. The intervenors in the case, which include appellant herein, were similarly situated.[2]

Amicus contends that combined reporting which would include in the tax base the income earned without the United States by entities incorporated under the laws of a foreign nation fails Commerce Clause (Article I, Section 8, Clause 3) standards as set forth in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) (hereafter referred to as *"Japan Line"*), and *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, rehearing denied, 430 U.S. 976 (1977).

Amicus further suggests the proper answer which this Court should reach is to permit combined reporting of all entities doing business within the United States only as to their United States source income.[3] This solution, as hereafter discussed, will preserve the international harmony and fairness sought by the framers of the Commerce Clause in the Constitution, eliminate the complex problems of information gathering which mar the alleged simplicity of reporting claimed by the states in their use of appor-

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2. Amicus is primarily concerned with foreign based unitary businesses with United States subsidiaries. The Illinois Income Tax Act and Proposed Regulations, thereto (Appendices E and G to Appellant's Jurisdictional Statement, respectively, all references hereafter to Appellant's Appendices to refer to the Appendices to Jurisdictional Statement) do not contain any apparent exception from worldwide combined reporting for such businesses.

3. The United States factors would be included and factors outside the United States would be excluded from the apportionment formula. This case does not raise the question of the foreign source income of a single corporation doing business within and without the United States, and Amicus specifically requests the Court not to reach this issue. Amicus believes that there may be differences in the proper analysis where a foreign corporation, foreign-owned, is doing business within and without the United States as opposed to a United States corporation, domestically owned.

tionment, and still preserve a state's freedom to construct its own taxing methods within the geographic confines of the entire United States.

I. The Same Tests of Validity of a State Taxing Statute Under the Commerce Clause Should Be Used for Income Taxation of a Unitary Business Engaged in Foreign Commerce as for Property Taxation of an Instrumentality of Foreign Commerce.

The tests developed in *Complete Auto Transit Inc. v. Brady, supra,* (application to an activity with a substantial nexus with the state, fair apportionment, non-discrimination against interstate commerce and fair relationship to services provided by the state) have been applied to all forms of taxation of interstate business, including income tax. See, e.g., *Moorman Manufacturing Co. v. Bair,* 437 U.S. 267 (1978). Amicus discusses in Part IV of this brief whether the combined reporting method is fairly apportioned when applied to foreign owned unitary businesses and whether such method discriminates against foreign-owned businesses. Amicus believes that upon careful scrutiny such application fails even the basic tests of *Complete Auto Transit, Inc. v. Brady, supra.*

However, the additional two tests developed in *Japan Line* (hereafter referred to as "*Japan Line* Tests Five and Six"), should have particular applicability in measuring compliance with the Commerce Clause when dealing with questions of foreign commerce. The *Japan Line* tests should not be restricted to instrumentalities of foreign commerce but should apply to all foreign commerce: the intrusion of the states into areas of foreign commerce is no less burdensome because the states select one method or one object of taxation as opposed to another.

The Supreme Court of Illinois distinguished *Japan Line, supra,* on the basis that combined reporting did not involve multiple taxation of items of foreign commerce or affect

the federal authority in governing foreign commerce. Since the purpose of the apportionment formula was to confine taxation of business income to the portion attributable to activities within Illinois, the court reasoned that the concern was only with the taxation of business income fairly attributable to activities within Illinois.

The purpose of *any* apportionment formula—including the formula used by California in *Japan Line, supra,* is to confine the taxes levied on the object of taxation—whether it be income or instrumentalities of commerce—to the taxing authority's "fair share." And, as this Court pointed out in *Japan Line,* even a fairly apportioned state tax may fail the Commerce Clause standard where foreign commerce is involved. 441 U.S. at 448.

Applying an apportionment formula to worldwide net income to determine the share of that income to tax is no different than using a port-day formula to determine the share of the value of containers to tax. If the containers are used in foreign commerce, the question is one of foreign commerce. If the activities of the unitary business involve foreign commerce, the question should also be one of foreign commerce. Both the Appellant and Caterpillar Tractor Co. have multinational subsidiaries whose income would be combined as part of the tax base. That income was earned in activities in foreign commerce.

II. The Use of Worldwide Combined Reporting Increases the Risk of Multiple Taxation Beyond the Acceptable Commerce Clause Limits.

The first of the additional inquiries added by this Court in *Japan Line* to test the validity of a state taxing statute under the Commerce Clause is:

> "Whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation...." 441 U.S. at 451

This Court went on to point out in footnote 17:

> "Because California's tax in this case creates multiple taxation in fact, we have no occasion here to decide under what circumstances the mere *risk* of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed to interstate, commerce." 441 U.S. at 452 (citations omitted)

In its more recent decisions involving interstate commerce, this Court has not found actual multiple taxation and has perhaps suggested that in the domestic context something more than the speculative possibility of such multiple taxation must be present. See, e.g., *Moorman Manufacturing Co. v. Bair, supra; Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425 (1980). Moreover, this Court has been loath to decide, in domestic situations, which taxing state may be "causing" the possible multiple taxation. *Id.*

This case, however, involves foreign, as well as interstate, commerce, and more than the theoretical risk of taxation rejected by this Court in *Mobil Oil Corp. v. Commissioner of Taxes, supra.* Unlike New York which had not imposed any tax on dividends received by its commercial domiciliaries, most foreign nations do tax income earned within their borders under the "arm's length" method.[4]

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4. The arm's length method of accounting is a corollary of "separate accounting" which allocates the business income of a single entity to a geographic location. To deal with transactions between related entities, an arm's length standard is used. If such transactions do not meet the "arm's length" standard, they can be reallocated by taxing authorities. See e.g., Section 482 of the Internal Revenue Code. Many states have statutes similar to Section 482, including Illinois. See Illinois Income Tax Act Section 404 (Appellant's Appendix E at E-26).

There is no showing of actual multiple taxation in the record, but Amicus urges the Court to require only the risk of multiple taxation and not its actual presence. The differences between taxation of foreign and domestic commerce require a different result: the presence of an international standard of taxation which differs in concept and practice from the unitary method will result in multiple taxation in certain circumstances, and, because the standard has been adopted by foreign sovereigns, this Court has no authority to require apportionment as a cure for multiple taxation.

A. THE INTERNATIONAL STANDARD OF INCOME TAXATION ADOPTS A WATER'S EDGE APPROACH.

This Court pointed out in *Japan Line* that the custom of nations, as well as various treaties to which the United States was a party, permitted the domiciliary nation to tax instrumentalities of commerce in full at their domicile. There is a similar international income tax standard memorialized in numerous treaties of double taxation to which the United States is a party.[5]

This international standard is described in the Memorandum Report, dated September 4, 1981 ("Report"), of the staff of the Advisory Commission on Intergovernmental Relations:

> "The gain to the nation from reducing tax-based barriers to the free movement of resources across national borders is clear. What must also be made clear is that there are requirements to be met before these gains can be realized. Specifically, tax harmonization cannot occur without an *internationally accepted set of standards* which serve as the foundation for all tax treaty negotiations.

5. The United States is a party to treaties of double taxation of income with over 50 nations.

"Internationally Accepted Standards

"These internationally accepted standards set forth principles for taxing foreign owned enterprise operating in the United States and U.S. owned enterprise operating abroad. Two important sets of rules for this purpose are: (1) those defining a *permanent establishment* in the host country, since the host country can only tax business profits attributable to such a permanent establishment, and (2) those specifying procedures for accounting for transactions between related parties in measuring the income of the permanent establishment. Under these latter rules, the permanent establishment, such as a branch or subsidiary corporation, is to be regarded as a *separate entity* and transactions between related parties are calculated on an *arm's length basis;* that is, as if the related parties were dealing with each other as independent enterprises at arm's length.

"These standards have evolved from about 50 years of effort on the part of both technical experts and negotiators of tax treaties. In 1932, the first tax convention to which the U.S. was a party, that is a tax convention with France, adopted the arm's length concept. In 1934, through work supported by the League of Nations, the first model tax treaty was developed incorporating the arm's length standard. The model income tax treaty of the Organization for Economic Cooperation and Development (OECD), most recently revised in 1977, similarly embraces this arm's length concept as does the United States' model tax treaty also most recently issued by the Treasury Department in 1977.

"Thus, the standard reflected in both OECD and United States model income tax treaties is a 'water's edge' rule." (Footnotes omitted; emphasis in original) Report, pp. 8-9.

See also, Treasury Department Tax Reform Option Paper No. VIII, Appellant's Appendix F.

This concept is in contrast to the unitary method and most particularly to its extension, combined reporting, which ignores geographic boundaries.[6]

B. THE CONCEPTUAL DIFFERENCES BETWEEN COMBINED REPORTING AND THE WATER'S EDGE INTERNATIONAL STANDARD RAISE A SUBSTANTIAL RISK OF MULTIPLE TAXATION.

Because the principles underlying the two methods of taxation—water's edge[7] and worldwide combination and apportionment—are different, a corporation or group of corporations, engaged in business both within and without the United States, always runs a risk of multiple taxation. Whether actual multiple taxation may occur depends upon circumstances from year to year, often on the location of profits of a business within and without the United States.[8]

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6. Mr. Dexter in his brief on behalf of the Multistate Tax Commission in response to the jurisdictional statement contends that there is nothing in the record to substantiate appellant's argument "that the unitary method here involved conflicts with such [international] standards, agreements and norms." Footnote 9 at p. 5. Amicus suggests that this Court can take judicial notice of treaties, treatises and legislative testimony on this subject to find more than sufficient evidence. However, since Amicus primarily represents foreign parents with both domestic and foreign subsidiaries, Amicus would like to point out Mr. Dexter's apparent concession that evidence of such accords does exist in the case of foreign parents:

> *"While there may be international agreements between the United States and certain other nations pertaining to taxation of the domestic operations of foreign parent corporations,* no such agreements exist as to how nations will tax their own domestic corporations...." *Id.*

7. The term "water's edge method" for purposes of this brief will mean separate accounting within the territorial limits of the taxing jurisdiction with an arm's length standard applied to transactions between related entities.

8. When a unitary business reports a greater percentage of its net income outside the United States than within with respect to the average of the formulary apportionment factors, the form-

The following simplified example illustrates the clash between the two concepts of taxation when applied to a unitary business conducted by a foreign parent and a U.S. subsidiary. The foreign parent does all of its business in a foreign country. The subsidiary does all of its business in Illinois. The net income earned by the foreign country corporation is One Million Dollars as measured by the laws of that country (and translated into U.S. dollars). The net income earned by the subsidiary is Five Hundred Thousand Dollars as measured by United States federal income tax law. Under both the arm's length method and the unitary method the total net income of the two corporations is One Million Five Hundred Thousand Dollars.[9] Under the foreign country's taxing system which is the standard water's edge concept One Million Dollars will be subject to tax. The foreign country has no claim to, or interest in, the balance of the income until it is repatriated. Under the unitary system, some share of One Million Five Hundred Thousand Dollars, or the aggregate of the taxable incomes of the two corporations, will be subject to tax by Illinois. What that share will be will depend upon a formula based on the relation of factors within Illinois to factors worldwide (generally property, payroll and sales). If the formula results in a relationship of factors which in turn

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ulary apportionment will "reach" some of that income. For example, if corporation A, doing business without the U.S., reports net income of $100,000 and corporation B, doing business within the U.S., reports net income of $50,000, for a worldwide income of $150,000, and if the factors of these corporations are equal, under the combined reporting method, B's net income for tax purposes will be regarded as increased from $50,000 to $75,000.

9. The practice in those states applying combination is usually to combine the net income of each separate entity to arrive at worldwide net income with some adjustments to conform the base to United States' standards of accounting and the state's tax. See e.g., Proposed Illinois Income Tax Regulations, Section 304-1(b)(2), Appellant's Appendix at p. G-17.

produces a percentage greater than thirty-three and one-third percent, Illinois will claim the right to tax more than Five Hundred Thousand Dollars. If the percentage is less, the share claimed will be less. If, in our example, the percentage derived from the relationship of the factors is fifty percent, Illinois' share of the income to be taxed will be Seven Hundred Fifty Thousand Dollars. Since the unitary business is already subject to tax on One Million Dollars under the first concept, "the aggregation of taxes" (*Japan Line,* 441 U.S. at 447) is actually being computed on more than the agreed full value of the tax base of One Million Five Hundred Thousand Dollars, namely, One Million Seven Hundred Fifty Thousand Dollars.

Taxpayers have not been successful in proving double taxation in the income tax context before this Court. Offers of proof have generally been based on the taxpayer's financial accounting offered as a contrast to the state result. See, e.g., *Moorman Manufacturing Co. v. Bair; Exxon Corporation v. Wisconsin Department of Revenue,* 447 U.S. 207 (1980). Where, however, separate accounting is the preferred approach of a foreign sovereign which has the jurisdiction to tax, evidence of that jurisdiction's *tax base* cannot and should not be rejected. If that tax base, when added to the base of the state determined under the unitary method, exceeds the total tax base, that business is subject to multiple taxation. Because of this every unitary business subject to tax in a state which uses worldwide combination and also subject to tax in a foreign jurisdiction which adopts the international standard bears a burden quite different than a domestic unitary business not doing business in such foreign jurisdiction. Although combined reporting may be facially neutral, in practice it subjects such businesses to the risk of burdens not borne by others. *Japan Line, supra.*

C. THIS COURT HAS NO POWER TO PREFER THE APPORTIONMENT METHOD OF COMBINED REPORTING OVER AN INTERNATIONALLY ACCEPTED CONCEPT IN THE CONTEXT OF FOREIGN COMMERCE.

Prior to *Japan Line* this Court had been able to set itself up as arbiter, in Commerce Clause inquiries, between competing tax systems, and had the luxury of choosing or declining to choose which of the competing methods of taxation to which a business was subjected—or might be subjected—was the cause of possible unfairness.

In *Japan Line,* however, this Court faced a situation where it was clear that there were two competing approaches to taxation, and, even though this Court preferred one system—namely apportionment—it was powerless to reconcile differences. It could not command a sovereign state to change its system, particularly where this system was part of an international approach accepted by the United States through its treaties.[10]

Likewise, in this case this Court is powerless to compel a foreign country to abandon its own water's edge standard to accept some form of unitary apportionment. As this Court has pointed out in *Japan Line, supra,* the "basis for this Court's approval of apportioned property taxation ... has been its ability to enforce full apportionment by all potential taxing bodies." 441 U.S. at 447. But where multiple taxation is a substantial risk as here,[11]

> "[d]ue to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax,

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10. Like treaties of double taxation, the Customs Convention on Containers did not specifically deal with state as opposed to federal taxation.

11. Since the water's edge system taxes on a geographic basis (income earned within borders) and worldwide combined reporting ignores geographic boundaries, it is highly likely, as in the example at pages 11-12 of this brief, that each system will claim an overlapping portion of the total tax base, *i.e.*, worldwide net income.

even though 'fairly apportioned' to reflect an instrumentality's presence within the state may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed and which the Commerce Clause forbids.'" *Japan Line, supra,* at 447-448 quoting *Evco v. Jones,* 409 U.S. 91 at 94 (1972), and *J. D. Adams Mfg. Co. v. Storen,* 304 U.S. 307 at 311 (1938)

D. IN FOREIGN COMMERCE THE RISK OF, RATHER THAN ACTUAL, MULTIPLE TAXATION SHOULD BE SUFFICIENT TO INVALIDATE COMBINED REPORTING BECAUSE THE RISK IS IDENTIFIABLE.

Amicus suggests to this Court that the risk of multiple taxation inherent in the application of worldwide combined reporting to income of entities not doing business within the United States should be sufficient to invalidate its use when applied beyond the United States. The risk is systemic and identifiable: so long as a sovereign nation adopts a method of taxation in accord with the water's edge concept, as do most nations, and states such as Illinois adopt worldwide combined reporting which does not limit itself to geographical boundaries, multiple taxation will occur if the apportionment method includes in its tax base more than *U.S. source income as identified by the international standards.*

This is not the speculative risk of *Mobil Oil Corp. v. Commissioner of Taxes, supra,* where there was multiple taxation only if New York chose to tax dividend income by allocation and where such multiple taxation can be corrected by this Court—presumably by requiring apportionment.

This Court has recognized that differing systems of taxation and differing formulas will produce multiple tax. See *e.g., Mobil Oil Corp. v. Commissioner of Taxes, supra; Standard Oil v. Peck,* 342 U.S. 382 (1952); *Moorman Manufacturing Co. v. Bair, supra,* at 277, fn. 2. The only

uncertainty is whether in any given year the two incompatible systems will produce multiple taxation.

Because this risk inheres in the *system* and is identifiable, proof of actual multiple taxation should not be necessary.[12]

E. THIS COURT CAN ELIMINATE EVEN THE RISK OF MULTIPLE TAXATION BY LIMITING COMBINED REPORTING TO THE UNITED STATES.

This Court can eliminate all risk of, and any actual, multiple taxation by limiting the application of combined reporting to the water's edge of the United States. Thus, combined reporting cannot include in its share of the tax base that potential overlap between the state's claimed share and the share determined under the international standard: there is no overlap.

The limitation to water's edge preserves the freedom of the states to experiment within the entire United States with their own approaches to tax.[13] There is no necessity to invalidate the entire state's taxing statute: there seems to be no constitutional reason under the Commerce Clause why combined reporting could not be limited to the United States where this Court can correct inequities when they arise.[14] The amount of United States income of a unitary

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12. Amicus does not describe this as a *flaw* in the system; it is simply different than the other system accepted internationally, and, as this Court recognized in *Moorman Manufacturing Co. v. Bair*, differences in systems produce duplicative tax. 437 U.S. at 278.

13. It should be noted that not all states adopt the unitary concept, and that most do not use either worldwide combined reporting or combined reporting. There are also numerous variations on formulas as this Court was well aware in *Moorman Manufacturing Co. v. Bair*. To transfer these questions into the international sphere will add needless complexities to an already complex area.

14. Amicus' comments are confined to the application of the Commerce Clause in the context of a unitary business doing business within and without the United States and it does not comment on any other Constitutional impediments that may arise from the application of combined reporting within the context of interstate commerce.

business is readily available and many of the states use the federal tax base as the starting figure.[15]

This approach will also save this Court (and other courts) from the avalanche of highly technical cases seeking to prove mulitple taxation in the year in which it occurs. The risk of multiple taxation is identifiable but is not quantifiable except on a year by year basis. To expect a taxpayer to continually litigate in those years when the extent of such multiple taxation is known leads to poor tax policy and administration since it leaves unsettled an area which this Court can settle.

In these very murky international waters, the time of this Court would be better served by finding that the export of this system beyond the water's edge is not proper.

III. Worldwide Combined Reporting Impairs Federal Uniformity in an Area Where Federal Uniformity Is Essential.

The second of the additional Commerce Clause inquiries made by this Court in *Japan Line, supra,* is:

> "Whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" 441 U.S. at 451.

Foreign commerce is preeminently a matter of national concern. This Court has stressed in *Japan Line, supra,* and numerous other cases the need for a national approach in "foreign intercourse and trade" and uniformity in treating with other nations.[16] Examples of how a state tax on instrumentalities of foreign commerce might frustrate the achievement of federal uniformity are described by this Court in *Japan Line*:

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15. See e.g., Illinois Income Tax Act, Section 203 (Appellant's Appendix E at p. E-3 et seq.).

16. See e.g., *Gibbons v. Ogden,* 9 Wheat. 1 (1824); *Board of Trustees v. United States,* 289 U.S. 48 (1933); *Zschernig v. Miller,* 389 U.S. 429 (1960).

> "If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States follow the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign commerce." 441 U.S. at 450-451 (footnotes omitted).

This Court pointed out that the tax in question in *Japan Line, supra,* also conflicted with a national policy, evidenced by the Customs Convention on Containers, to remove impediments to the use of containers as instruments of international traffic. The asymmetry created by the California tax, which operated to Japan's disadvantage, would undoubtedly prompt retaliation. One other state (Oregon) was already following this approach, thereby subjecting foreign-owned containers to various degrees of multiple taxation, dependent upon which American ports they would enter.

The effects of combined reporting are strikingly similar when applied to a worldwide unitary business which is foreign-owned and controlled.[17] Because Illinois has no

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17. The Appellant and Appellee, Caterpillar Tractor Company, are domestic businesses. Many of the arguments which Amicus makes in this section may or may not apply to domestic businesses. However, the difficulties which worldwide combined reporting are causing in international relations are sufficiently serious to be brought to this Court's attention.

exemption in its statute for such entities, and, because California which has a similar statute is already applying worldwide combined reporting to foreign-owned entities,[18] Amicus urges this Court to consider the effects of this statute on all potential taxpayers to avoid needless litigation. As Mr. Justice Powell suggested in his dissent in *Moorman Manufacturing Co. v. Bair, supra,* the Commerce Clause inquiry into whether a statute has a particularly burdensome or discriminatory effect is not tied to the effect on a particular corporation's income but focuses on the impact on commerce in general. Footnote 3, 437 U.S. at 287.

A. WORLDWIDE COMBINED REPORTING FRUSTRATES THE ACHIEVEMENT OF FEDERAL UNIFORMITY.

The Court's first illustration of the effect of the property tax on instrumentalities of commerce was the possibility of international disputes over the reconciliation of apportionment formulae. Worldwide combined reporting, because it is different than the water's edge international standard used by most other nations, will bring this Court into exactly those types of international disputes. Amicus has shown in Part II of this brief that the two approaches automatically produce conflict. It is difficult enough to attempt to reconcile apportionment formulae in interstate commerce.

To add the dimension of foreign commerce where the Court admits it has no authority to effect such a reconciliation, and where there is really no international tribunal available to do so, could very well lead to the second frustration which the Court predicts, namely retaliation by foreign nations against American businesses abroad. The concern

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18. See *e.g., Appeal of Beecham, Inc.,* California State Board of Equalization, March 2, 1977; *Appeal of Shachihata, Inc.,* California State Board of Equalization, January 9, 1979.

of such nations has already been expressed by, among others, Belgium, Canada, France, Italy, the United Kingdom, and the nine governments of European Economic Community ("EEC").[19]

Finally, if other states follow the example of the State of Illinois (and those very few states which presently apply combined reporting), foreign-owned businesses and domestic businesses could be subjected to the varying degrees of multiple taxation which would clearly prevent this nation from speaking with one voice in regulating foreign commerce. The impact of this is perhaps best stated in the Motion of the Appellee, California Franchise Tax Board, to dismiss or affirm the petition of Container Corporation of America (No. 81-523) October Term, 1981, filed in this Court:

> "There is *no* absolute uniformity among income tax laws.[4]

"4. Income tax statutes of different states and countries indicate that even where based on separate accounting principles the method of measuring the net taxable income would have some differences in each jurisdiction. There seem to be numerous differences in what are considered *business* income and expenses, and deductions allowed for depreciation and depletion. Statutory difference would seem to be multiplied when individual administration and determinations as to 'reasonable' amounts (particularly allowable as business deductions) enter into the calculations of taxable net income.

"Even the Uniform Division of Income for Tax Purposes Act (UDITPA) used by California (which has been adopted by a number of states and appears to be one of the most uniform methods of apportionment) has some variations among the jurisdictions. It is believed that there is no reasonable possibility of insuring that 100% and only 100% of the income of a unitary business operating in several taxing jurisdictions is included in tax measures." At page 31 of brief (Emphasis in original).

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19. Attached as Amicus' Appendices D through G are the texts of the objections of Canada, France, the United Kingdom and the EEC.

This Court has made it clear in *Japan Line,* that "even a slight overlapping of tax—a problem that might be deemed de minimis in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." 441 U.S. at 456.

It might be argued that since this case involves only a domestic appellant, most of these difficulties will not arise. Nevertheless, the difficult problem of reconciling the myriad and non-uniform state systems with the different systems used abroad still will have an adverse impact upon domestic corporations although the threat of retaliation may not be present. Thus, this case still involves sensitive international relations and the potential threat of retaliation. Moreover, foreign governments will be interested in this case because it does involve subsidiaries organized under foreign law and may be indicative of treatment of foreign-owned parents as well.

B. WORLDWIDE COMBINED REPORTING IMPINGES UPON THE NATIONAL POLICY OF REMOVING IMPEDIMENTS TO THE FREE FLOW OF TRADE AND COMMERCE.

This Court in *Japan Line, supra,* pointed out that the desirability of uniform treatment of containers used exclusively in foreign commerce was evidenced by the Customs Convention on Containers which the United States and Japan had signed. The Court stated that the Convention reflected a national policy to remove impediments to the use of such containers in international trade.

The United States has embarked on a similar national policy as reflected in its many treaties of double taxation and its general treaties of friendship, commerce and navigation.

The purpose of the treaties of double taxation is to insure uniformity of treatment of the nationals of contracting

states abroad and reflects a recognition that systems of taxation may in and of themselves be impediments to the free flow of trade. Accordingly, the objective is to reduce the possibility of double taxation by the utilization of accepted standards.

The accepted standard in this network of treaties is the water's edge standard as described in Part II of this brief. Combined worldwide reporting is an asymmetric system.

If this case had as its appellant a foreign-based business, the subversion of this national policy would be obvious. Nationals of the other contracting parties when they come to the United States find themselves not only subject to taxation by the states, which is entirely proper, but, with worldwide combined reporting, taxation by a system which has extraterritorial implications with effect beyond the borders of the United States. This is not simply the problem of multiple taxation; it also includes extensive compilation of information on activities of businesses beyond the borders of the United States, demands not only burdensome but perceived by foreign business as an attempt to export this system.[20]

Because this case involves domestic businesses, the impact upon such national policy is not as readily apparent. However, the fact that this form of taxation has already generated governmental protests to the *federal government* (see Amicus' Appendices D through G) and has been the subject of extensive debate in the British House of Com-

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20. See Statement of John S. Nolan on behalf of Confederation of British Industry and the British National Committee of the International Chamber of Commerce before House Ways and Means Committee on HR 5076, Appellant's Appendix I. See also Part IV of this brief.

mons[21] shows that the matter is one of national—and international—concern.

As the Court pointed out in *Japan Line, supra,* Illinois has created a problem, the solution to which is only in national or international hands. This is a clear undermining of national objectives and prevents our nation from speaking with one voice.

IV. Worldwide Combined Reporting When Applied to Foreign Based Taxpayers Unfairly Apportions Income and Discriminates Against Foreign Commerce.

This Court in *Complete Auto Transit Co. v. Brady, supra,* set forth four basic tests to measure compliance of state taxing statutes against the strictures of the Commerce Clause. Amicus believes that worldwide combined reporting when applied to a unitary business controlled by a foreign

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21. For example in debates in the House of Commons on the United States-United Kingdom Tax Treaty on February 18, 1980, the unitary system was described as "international robbery," and Peter Rees, Minister of State, Treasury, made the following statement:

> "To those who remain concerned about the unitary question, I say that there is no disposition on the part of the Government to let the issue die. If the House approves the convention and if it is ratified thereafter, we shall be prepared to place on record, for all to see, our reservations on the unitary system. The Administration in the United States were left in no doubt by what I told them.
>
> "Between two sophisticated and old friends such as the United States and the United Kingdom fiscal matters are subject to continuing review, and I assure the House that there will be an annual review of the working of this double tax convention. It is absurd for it to be raised automatically every year, but when the moment is propitious we shall be prepared to raise it again.
>
> "The British ambassador in Washington at this moment is mustering the EEC ambassadors to see what kind of common *demarche* can be made on the subject." Hansard, Parliamentary Debates, p. 179.

corporation fails at least two of the four *Complete Auto* tests, namely fair apportionment and nondiscrimination.[22]

The tax is not fairly apportioned because the formula used does not limit the tax to the activities of the business within the state. This is chiefly because the instate apportionment factors (which appear in the numerator) are not of the same quality and relationship as the "offshore factors" which appear in the denominator. The various factors, although using identical labels, are not measuring the same thing.

The most common factors, such as those used in the Illinois Income Tax Act, are property, payroll and sales. The definition of what is included in each of these factors is based upon United States tax and accounting principles. These principles often differ substantially from the accounting and tax principles used in foreign countries. It is the latter which control the recordkeeping of such foreign companies. For example, the books and records of foreign taxpayers with respect to property are often based on replacement cost or in some cases, inflation accounting. United States accounting (and state tax accounting) is based on historical cost (see e.g., Illinois Income Tax Act, Section 304(a)(1)(B), Appellant's Appendix E at p. E-16). Some European countries not only quickly depreciate but actually eliminate from the books certain items of personal property. As a result information is often not available to make the property factors correspond.

The relationships of the factors to the income produced is also different. The economic basis of the unitary formula

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22. The questions of noncompliance with Due Process and Equal Protection standards are already raised by appellant herein. Because of this Amicus makes no comment with respect to the Due Process questions which are somewhat similar to the second and third tests of *Complete Auto Transit Co. v. Brady, supra,* or with respect to the application of these Commerce Clause tests to domestic taxpayers.

is that a dollar of income, a dollar of property, and a dollar of sales in the taxing jurisdiction all contribute more or less proportionately to profits as do a dollar of income, a dollar of property, and a dollar of sales outside the taxing jurisdiction. Within a single economic system distortions in segments of a business tend to more or less even out. However, in different types of economies, particularly those where the costs inherent in the factors and the expectations for profit differ markedly from the United States and where the nature of the economy is often quite different, the mixing of the differences produces a greater distortion than would appear in a uniform economy. Appellant in its jurisdictional statement has mentioned the high cost of compliance with environmental standards (at pp. 28-29) which in turn increases the property factor in the United States. Taxpayers which invest in countries where the risk of expropriation is high are likely to require greater profit margins to justify the additional risk.

None of these problems by themselves might seem unfair, but their aggregation creates a pattern of unfairness in the apportionment formula. Foreign-based taxpayers have perceived this and have complained that the unitary theory of apportionment singles them out for arbitrary and unfair taxation, the evils proscribed by the two *Complete Auto Transit* tests. See, e.g., Hearings before the California Franchise Tax Board in July and August, 1977 on the California Unitary Tax; Hearing before California Assembly Revenue and Taxation Committee, November 13, 1979 (*Transcript, Unitary Apportionment and Worldwide Combination,* Volume III); and particularly the statement of Lever Brothers Company, reproduced at pp. 445-462 in Publication No. 750, *Background Information on California Bank and Corporation Tax, Unitary Method of Apportion-*

ment, Volume II, prepared by the Staff of the California Assembly Revenue and Taxation Committee for Interim Hearing, November, 1979.

The tax also discriminates in practice against foreign commerce as conducted by foreign owned unitary businesses.

The costs of compliance with state substantive tax laws are different and greater for foreign taxpayers than domestic taxpayers under worldwide combined reporting. For example, the Proposed Regulations to the Illinois Income Tax Act require each entity in a group to compute U.S. federal income or its equivalent even though such entities may not be doing any business in the U.S. and do not keep their books and records in accordance with U.S. accounting principles, let alone U.S. federal tax law.[23] This may be burdensome for a domestic taxpayer but at least it starts with U.S. accounting principles. At the hearings in California referred to above one foreign based taxpayer with less than 10% of its business activity in the United States and with less than 1% in California submitted a statement that its general books of account were maintained under the financial reporting laws of the country in which the parent corporation was organized using replacement costs instead of historic costs. To convert the books of its 500 subsidiaries located in over 70 countries to the peculiar requirements of California would be an enormously difficult task, involving reconstruction of the cost records of assets acquired over a period of many years, and taking into account changes in the exchange rates from the various host currencies into dollars from time to time.

This Court has also recognized the practical difficulties that arise in trying to reconcile different formulae. For example, the Court specifically referred in footnote 15 in

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23. See Proposed Illinois Income Tax Regulations, Section 304-1(b)(2), particularly at p. G-19, Appellant's Appendix G.

Japan Line, 441 U.S. at 450 to the difficulty, pointed out by a note in the *Harvard Law Review,* of allocating international bridge time for aircraft engaged in international commerce, with a consequent risk of multiple taxation from overlapping apportionment formulae.[24] Among the practical difficulties arising from worldwide combination, which are exacerbated in the case of foreign parents, is the problem of currency translation. Since the books and records of foreign entities are kept in the currency of their domicile, standards of translating currency (not simply in terms of dollars to foreign currency relationships, but also in terms of timing) have proved difficult to establish and administer. For example, several methods are available to translate foreign income into U.S. income.[25] Financial Accounting Standards Board Statement No. 8[26] requires the use of a variation of the net worth method in accounting for profits for financial purposes. The states have only begun to address the intricacies of income translation. If the states are left to promulgate their own versions, a wide range of translation standards could be applied to a foreign based taxpayer engaged in business in more than one state.

Changes in foreign exchange rates often result in haphazard calculation of apportionable worldwide income. To illustrate, consider the reported income from the annual reports of Unilever Limited and Unilever, N.V. filed with the Securities and Exchange Commission. Unilever Limited is a British corporation linked by a common Board of Direc-

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24. "Developments In the Law—Federal Limitations on State Taxation of Interstate Business," 75 *Harv.L.Rev.* 953, 986 (1962).

25. See generally, Donald R. Ravenscroft, *Taxation and Foreign Currency,* Harvard Law School 1973, for a description of the net worth, profit and loss, combination and other methods used for federal tax purposes.

26. *Accounting for Translation of Foreign Currency Transactions and Foreign Currency Financial Statements,* American Institute of Certified Public Accountants (1975).

tors and a profit equalization agreement with Unilever, N.V., a Dutch corporation. The same combined income is reported in pounds for the British corporation and in guilders for the Dutch corporation. The annual reports yearly contain exchange rate data with regard to income calculation in terms of pounds and guilders. The 1978 annual report notes at page 5:

> *"Exchange Rates*
>
> "There continued to be sizeable movements in exchange rates between the major currencies. The most important feature was the weakening of the U.S. dollar in the second half of the year against almost all other major currencies. Sterling weakened against the guilder and the deutschmark, but strengthened against the dollar. At the end of 1978 the sterling/guilder rate was £1 = Fl. 3.99, compared with £ = Fl. 4.36 at the end of 1977.
>
> "For the purpose of calculating the 1978 combined results we have used the sterling exchange rate current at the year-end of 1978. Combined earnings per share rose by 6 per cent in sterling and fell by 3 per cent in guilders. If the combined results had been calculated at the same rate of exchange as those for 1977, earnings per share would have risen by 9 per cent in both currencies."

This annual report illustrates that income determination depends upon movements in foreign currency exchange rates which have nothing to do with earnings from operations in a tax jurisdiction.

Where the percentage of business conducted in the U.S. is relatively small, changes in the value of the dollar will have a significant effect on the amount of income subject to tax. To illustrate, assume that a British corporation engaged solely in business in Great Britain establishes a U.S. subsidiary. Assume further that 90.91% of combined business is conducted in Great Britain while the remaining

9.09% is carried on in Illinois. The parent corporation earns £100 and the U.S. subsidiary earns $20 (£10 at a £1 = $2.00 exchange rate). During a tax year the value of the dollar with respect to the pound declines by 20% and the exchange rate becomes £1 = $2.40. If the exchange rate had not changed, income subject to apportionment would be £110 or $220.00; with the new exchange rate income subject to apportionment increases to $264.00, an increase of $44.00, some $24.00 more than the hypothetical income of the U.S. subsidiary. Since most foreign based taxpayers have a much greater proportion of business activity outside the United States than within, foreign based taxpayers feel the effect of exchange rate changes more acutely than domestic based taxpayers.

These problems of distortion and administrative burden are peculiar to unitary combination of foreign source income. As this Court has said:

> ". . . [t]he apportionment theory is a mongrel one, a cross between desire not to interfere with state taxation and desire at the same time not utterly to crush out interstate commerce." *Northwest Airlines, Inc. v. Minnesota,* 322 U.S. 292 at 306 (Jackson concurring) (1944).

It is respectfully suggested that this Court specifically recognize, in applying *Complete Auto Transit* standards, that the validity of a tax measured by combining foreign corporations with domestic corporations be subject to rigorous examination to protect against unfair and capricious assessment and most particularly its burdens on foreign taxpayers.

CONCLUSION

Worldwide combined reporting places an additional burden on foreign commerce not borne by domestic commerce. The problems of multiple taxation and impairment of the uniformity of federal policy are most apparent when combined reporting is applied to foreign owned entities. These difficulties still exist even with domestic owned entities engaged in worldwide commerce, and this Court can eliminate such burdens and avoid needless future litigation by confining the application of combined reporting to the boundaries of the United States. Amicus urges this Court to do so.

Respectfully submitted,

JOANNE M. GARVEY
ROY E. CRAWFORD

Attorneys for Amicus Curiae

Appendix A

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December 2, 1981

4648-79-1

Mr. Alexander L. Stevas
Clerk
Supreme Court of the United States
Washington, D.C. 20543

Re: Chicago Bridge & Iron Company v.
Caterpillar Tractor Co., et al.
No. 81-349

Dear Sir:

As counsel for Chicago Bridge & Iron Company, appellant in the above-entitled case, I wish to advise you that we have no objection to the filing of *amicus curiae* briefs by any person or organization, whether in support of our position, opposed to it, or otherwise. We do, however, object to the granting of permission to participate in oral argument to any *amicus*.

Very truly yours,
WILLIAM P. SUTTER

WPS:jll
cc: Mr. Don S. Harnack
Mr. John D. WhiteNack

Appendix B

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Mr. Alexander L. Stevas
Clerk
Supreme Court of the United States
Washington, D.C. 20543

Re: Chicago Bridge & Iron Company v.
Caterpillar Tractor Co., et al.
No. 81-349

Dear Sir:

As counsel for Caterpillar Tractor Co., et al., one of the appellees in the above-entitled case, I wish to advise you that we have no objection to the filing of *amicus curiae* briefs by individuals, corporations, organizations or states.

Very truly yours,
/s/ Don S. Harnack

DSH:mv

cc: Mr. William P. Sutter
Mr. John D. WhiteNack
Mr. William D. Dexter
Ms. Jean A. Walker
Ms. Joanne M. Garvey
Mr. Franklin C. Latcham
Mr. Derrick Takeuchi

Appendix C

ILLINOIS DEPARTMENT OF REVENUE

160 North LaSalle
Chicago, Illinois 60601
The Honorable Alexander Stevas
Clerk of the
Supreme Court of the United States
Washintgon, D.C. 20543

Re: No. 81-349
In the Supreme Court of the United States
Chicago Bridge & Iron Co., v.
State of Illinois, Department
of Revenue, et al., and
Caterpillar Tractor Co.
(Probable Jurisdiction Noted
Oct. 9, 1981)

Dear Sir:

This refers to the request in the copy of letter attached.

On behalf of the Illinois Department of Revenue, we hereby express that we have no objection to the filing of an amicus curiae brief, in support of the appellant, by Joanne M. Garvey of Jordan, Keeler & Seligman. FURTHER, we hereby state that we have no objection to the filing of *amicus curiae* briefs by any person or organization, whether in support of or opposed to our position, or otherwise.

Yours truly,
TYRONE C. FAHNER
Attorney General

December 4, 1981

cc: Joanne M. Garvey, Esq.
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LBF:mj
Encl.

Appendix D

Objections of Canada to State Unitary Taxation

September 26, 1980

The Honorable Allan J. MacEachen

Deputy Prime Minister and
Minister of Finance of Canada

Sir:

I have the honor to acknowledge receipt of your note of September 26, 1980, which reads as follows:

"I have the honour to refer to the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed today, and to confirm certain understandings reached between the two Governments with respect to the Convention.

1. In French, the term "societe" also means a "corporation" within the meaning of Canadian law.

2. The competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting States to establish its status as a religious, scientific, literary, educational or charitable organization entitled to exemption under paragraph 1 of Article XXI (Exempt Organizations), or as an eligible recipient of the charitable contributions or gifts referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. If a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Con-

tracting State shall accept the certification of the administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

It is further agreed that the term "family," as used in paragraphs 5 and 6 of Article XXI, means an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.

3. It is the position of Canada that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. Under that method the profit of a Canadian company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the Canadian company and its world-wide subsidiaries as well as the assets, payroll and sales of all such companies. For a Canadian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden. It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject.

4. I have the honour to propose to you that the present Note and your reply thereto shall constitute an agreement between our two Governments on these matters."

I confirm these understandings on behalf of the Government of the United States of America. These understandings constitute an agreement between our two Governments on this matter, which will enter into force on the date of entry into force of the Convention between the Government of the United States of America and the Government of Canada with Respect to Taxes on Income and on Capital which was signed today.

Accept, Sir, the renewed assurances of my highest consideration.

(Signed by: G. William Miller
Secretary of the Treasury)

Appendix E

Objections of France to State Unitary Taxation

November 24, 1978

Exchange of Letters on Execution of U.S.-France Protocol to Income and Property Tax Treaty of July 28, 1967 as amended by Protocol of October 12, 1971

His Excellency
Francois de Laboulaye
Ambassador of France

[Initial paragraphs dealing with certain U. S. reservations omitted]

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;

b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)(ii)(*c*) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The French Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) income. For example, if a taxpayer has a total income of $20,000 of which by reason of this Convention only $12,000 is taxable by France, the French tax will be 60 percent (12,000/20,000) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

George S. Vest
Assistant Secretary
for European Affairs

Appendix F

Objections of the United Kingdom to State Unitary Taxation

BRITISH EMBASSY,
Washington, D.C., June 23, 1980.

Hon. HARRY F. BYRD, JR.,
Russell Senate Office Building.
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD: In the context of the hearing of your Taxation Sub-Committee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note [copy attached] communicated to the Administration on March 25, 1980.

J. ANSON, *Minister, Economics.*

[Press release issued by the British Embassy Information Department]

U.K./U.S. DOUBLE TAXATION CONVENTION

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details, together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US, which was signed in London on 31 December 1975, and the three supplementary Protocols which were signed in London on 26 August, 1976, 31 March 1977 and 15 March

1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention, as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although the

local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organization for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention,

the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

Appendix G

Objections of European Economic Community to State Unitary Taxation

AMBASCIATA D'ITALIA.
Washington, D.C., March 19, 1980.

To the Department of State, Washington, D.C.:

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine EEC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

[Seal]

PAOLA PANSA CEDRONIO,
Ambassador of Italy.

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse

situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries."

7. The Federal Government uses the arm's-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty, Article 9(4) of the Treaty, which was supported by the Administration, would have disallowed the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9(4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9(4) was not to apply for the purpose of state taxation. Article 9(4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress, S 983, S 1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In the view of the strong arguments against unitary taxation, our Goverments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.